[JOINT COMMITTEE PRINT]

SUMMARY OF REVENUE PROVISIONS IN THE PRESIDENT'S FISCAL YEAR 1989 BUDGET PROPOSAL

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the Staff of the Joint Committee on Taxation, provides a summary of the revenue provisions in the President's Fiscal Year 1989 Budget, submitted to Congress on February 18, 1988.

The first part of the pamphlet is a summary of the revenue proposals contained in the Fiscal Year 1989 Budget, including present law and a reference to any recent prior action on the topic. The second part of the pamphlet presents the Administration's estimates of the revenue effects of the proposals, as they affect budget receipts.

The pamphlet does not include proposed technical corrections. Also, the pamphlet does not include budget proposals relating to an increase in the District of Columbia employer contributions to Civil Service Retirement, Nuclear Regulatory Commission fees, or certain other similar user fees proposals (other than the Customs Service user fee), which are included as budget receipt items in the President's budget.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Summary of Revenue Provisions in the President's Fiscal Year 1989 Budget Proposal* (JCS-1-88), February 29, 1988.

I. SUMMARY OF REVENUE PROVISIONS

A. Tax Provisions

1. Extension of Medicare Payroll Tax to All State and Local Government Employees

Present Law

Prior to enactment of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), State and local government employees were covered for social security and Medicare benefits only if the State and the Secretary of Health and Human Services entered into a voluntary agreement providing such coverage. In COBRA, the Congress extended Medicare coverage (and the corresponding hospital insurance payroll tax) on a mandatory basis to State and local government employees hired after March 31, 1986, for services performed after that date.

Under present law, State and local government employees hired before April 1, 1986, are not covered under Medicare unless a voluntary agreement is in effect. Currently, 70 percent of all State and local government employees are covered under a voluntary agreement. Medicare coverage (and the hospital insurance payroll tax) is mandatory for Federal employees.

For wages paid in 1988 to Medicare-covered employees, the total hospital insurance tax rate is 2.9 percent of the first $45,000 of wages (Code secs. 3101, 3111, and 3121). One-half of this tax is paid by the employee and one-half by the employer.

President's Budget Proposal

The President's budget proposal would extend Medicare coverage on a mandatory basis to all employees of State and local governments not otherwise covered under present law, without regard to their dates of hire. These employees and their employers would become liable for the hospital insurance portion of the FICA tax, and the employees would earn credit toward Medicare eligibility based on their covered earnings.

This proposal would be effective December 1, 1988.

Prior Action

During the 99th Congress, the Senate amendment to H.R. 5300 (the Omnibus Budget Reconciliation Act of 1986) included a provision similar to the President's budget proposal. This provision was deleted from the legislation in conference.

This provision in the President's budget proposal also was included in the President's budget proposal for fiscal year 1988.

2. Treatment of Mutual Fund Shareholder Expenses With Respect to the 2-Percent Floor on Miscellaneous Itemized Deductions

Present Law

For taxable years beginning after December 31, 1986, miscellaneous employee and investment expenses are generally deductible by itemizers only to the extent that such expenses exceed 2 percent of the taxpayer's adjusted gross income. As enacted in the Tax Reform Act of 1986, this 2-percent floor applies with respect to indirect deductions through regulated investment companies (mutual funds), i.e., certain investment expenses of such funds that would otherwise reduce shareholder taxable income are treated as miscellaneous deductions of individuals subject to the 2-percent floor.

The Omnibus Budget Reconciliation Act of 1987 (OBRA) delays treatment of shareholder expenses of publicly offered mutual funds as miscellaneous itemized deductions until taxable years beginning after December 31, 1987.

President's Budget Proposal

The President's budget proposal would permanently exempt shareholder expenses of publicly offered mutual funds from treatment as miscellaneous itemized deductions.

Prior Action

OBRA, as passed by the House and as submitted by the Senate Finance Committee to the Senate Budget Committee in October 1987, included the same provision as the President's budget proposal. This permanent provision was deleted from OBRA before its enactment.

3. Exclusion of Interest on Higher Education Savings Bonds

Present Law

There are no provisions in the present-law Federal individual income tax which exempt gross income or provide a tax deferral for interest income or other amounts that may be invested to fund post-secondary school educational expenses.

Certain types of income from savings arrangements are exempt from gross income or are not currently included in gross income of a taxpayer. For example, interest income on qualified State and local government bonds generally is exempt from Federal income taxation. Income credited to life insurance or annuity contracts (i.e., inside buildup) is not taxed until distributed to the policyholder, and is not taxed if paid to a designated beneficiary after the death of the insured individual (in the case of a life insurance contract).

In addition, taxation of the income earned on amounts contributed to an individual retirement arrangement (IRA) or an employer-maintained qualified pension plan is deferred until the amounts are distributed to the owner of the IRA or to the employee participating in the employer-maintained plan. Generally, amounts dis-

tributed prior to the attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax.

Taxation of interest accruals on Series EE savings bonds may be deferred by cash-basis taxpayers as long as the bonds are not redeemed.

President's Budget Proposal

The President's budget proposal would exclude from Federal income taxation the interest on certain savings bonds that are redeemed to pay certain post-secondary school educational expenses of the taxpayer or the taxpayer's spouse, children, or other dependents. The exclusion would be phased out for taxpayers with adjusted gross income above certain levels; the phase-out levels would be adjusted annually for inflation beginning in 1990. The amount of interest eligible for the exclusion would be limited to the total qualified educational expenses incurred.

The exclusion would apply to bonds issued after December 31, 1988.

4. Tax Credit for Qualified Research Expenditures

Present Law

The Tax Reform Act of 1986 extended the tax credit for qualified research expenditures for three years (i.e., through December 31, 1988) and reduced the credit rate from 25 percent to 20 percent.

Except for certain university basic research payments, the credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the specified base period, which generally is the preceding three taxable years. Eligible expenditures consist of: (1) "in-house" expenditures by the taxpayer for research wages and supplies used in research; (2) certain time-sharing costs for computer use in research; and (3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf. The 1986 Act provided a more explicit and targeted definition of research expenditures eligible for the credit.

Under the 1986 Act, the 20-percent tax credit also applies to the *excess* of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for university basic research *over* (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed base period, as adjusted for inflation.

President's Budget Proposal

The President's budget proposal would make permanent the 20-percent tax credit for qualified research expenditures.

Prior Action

The Tax Reform Act of 1986 (1) extended the research credit through December 31, 1988; (2) reduced the credit rate to 20 per-

cent; (3) narrowed the definition of research expenditures eligible for the credit; and (4) modified the university basic research credit.

5. Allocation and Apportionment of Research Expenses

Present Law

Computation of the foreign tax credit requires the taxpayer to distinguish between taxable income from U.S. sources and taxable income from foreign sources, and thus to allocate and apportion deductions among items of U.S.-source and foreign-source gross income. Treasury regulations prescribe a detailed method for allocating and apportioning research and experimental (R&D) expenses for this purpose, among others.

Effective for taxable years beginning after August 13, 1981, and on or before August 1, 1987, the R&D allocation regulation was suspended (for purposes of determining the source of taxable income) by a succession of statutes: the Economic Recovery Tax Act of 1981 (ERTA), the Deficit Reduction Act of 1984 (DEFRA), the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), and the Tax Reform Act of 1986 (TRA). In taxable years governed by ERTA, DEFRA, and COBRA, all U.S.-incurred R&D expenses were allocated to U.S.-source income. In taxable years governed by TRA, 50 percent of such expenses (other than amounts incurred to meet certain legal requirements, and thus allocable to one geographical source) were allocated to U.S.-source income, with the remainder allocated and apportioned either on the basis of sales or gross income.

President's Budget Proposal

For tax years beginning after August 1, 1987, taxpayers could allocate at least 67 percent of expenses for R&D to U.S. source income.

Prior Action

In COBRA, the 99th Congress extended by one year the ERTA/DEFRA moratorium on the R&D regulation. In TRA, the same Congress enacted the temporary allocation rule that generally allowed taxpayers to allocate at least 50 percent of domestic R&D expense to U.S. source income.

At a hearing before a subcommittee of the Senate Finance Committee on April 3, 1987, the Administration testified in favor of a proposal that would have made permanent a modified version of the TRA rules for allocating R&D expenses. The primary modification would have increased to 67 percent the proportion of U.S.-incurred expenses for R&D (other than amounts allocated to one geographical source because of legal requirements) automatically allocated to U.S. source income. That proposal was included in H.R. 3545, the Omnibus Budget Reconciliation Act of 1987 (OBRA), as passed by the House. The proposal was also included in the October 1987 budget reconciliation submission of the Senate Finance Committee to the Senate Budget Committee. The proposal was not included in the conference agreement on OBRA.

6. Foreign Corporation Branch Tax Credit

Present Law

The United States generally imposes a flat rate tax on dividends paid by U.S. corporations to foreign shareholders. The statutory flat rate is 30 percent, but income tax treaties sometimes require the United States to reduce the rate to as little as 5 percent. When a foreign corporation operates here, the United States generally imposes a "branch profits tax", which is a surrogate for the flat dividend tax, on the profits that the foreign corporation takes out of the United States.

When a foreign corporation that has borne one of these U.S. taxes (the foreign corporation having received a dividend from a U.S. corporation or having paid a branch profits tax) pays a dividend to a U.S. shareholder, the U.S. shareholder does not receive credit for the U.S. tax previously paid with respect to this income. Thus, the U.S. tax borne by the foreign corporation is in effect deductible rather than creditable, because it reduces the amount of dividend that the foreign corporation can pay.

Ten-percent or greater U.S. corporate shareholders in foreign corporations may deduct a fraction (generally 70 percent) of dividends attributable to the payor's U.S. income.

President's Budget Proposal

The President's budget proposal would provide a tax credit to U.S. shareholders of foreign corporations for U.S. branch taxes paid by the foreign corporations and for U.S. withholding taxes imposed on dividends paid to the foreign corporations. The proposal would also extend the dividends received deduction to less than 10-percent U.S. corporate shareholders in foreign corporations.

7. Modification of Oil and Gas Percentage Depletion Rules

Present Law

Under present law, independent oil producers and royalty owners (but not integrated oil companies) recover certain costs incurred prior to drilling an oil- or gas-producing property using the higher of cost or percentage depletion. Under percentage depletion, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year. The amount deducted may not exceed 50 percent of the taxable income from the property for the taxable year, computed without regard to the depletion deduction (the "net income limitation"). Additionally, the deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined with certain adjustments).

In addition, percentage depletion for oil and gas properties for independent producers and royalty owners is limited to 1,000 barrels of average daily domestic crude oil production (or an equivalent amount of natural gas). If an interest in a proven oil or gas property is transferred after 1974, production from that interest generally does not qualify for percentage depletion.

President's Budget Proposal

The President's budget proposal would increase the net income limitation from 50 percent to 100 percent.

In addition, the President's budget proposal would repeal the percentage depletion anti-transfer rules.

The proposals would be effective January 1, 1989.

Prior Action

The President's message to the Congress on May 6, 1987, on energy and national security concerns relating to oil import levels, contained the same recommendations.

8. Elimination of Superfund Petroleum Tax Differential

Present Law

Superfund taxes of 8.2 cents per barrel for domestic crude oil and 11.7 cents per barrel for imported petroleum products (including crude oil) are imposed on the receipt of crude oil at a U.S. refinery, the import of petroleum products and, if the tax has not already been paid, on the use or export of domestically produced oil.

Domestic crude oil subject to tax includes crude oil condensate and natural gasoline, but not other natural gas liquids. Taxable crude oil does not include oil used for extraction purposes on the premises from which it was produced, or synthetic petroleum (e.g., shale oil, liquids from coal, tar sands, biomass), or refined oil.

Petroleum products which are subject to tax upon import include crude oil, crude oil condensate, natural and refined gasoline, refined and residual oil, and any other hydrocarbon product derived from crude oil or natural gasoline which enters the United States in liquid form.

The petroleum tax generally expires on December 31, 1991. The tax will terminate earlier than that date if cumulative Superfund receipts during the reauthorization period equal or exceed $6.65 billion, and under certain other conditions.

Canada, Mexico, and the European Community filed a formal complaint under the General Agreement on Tariffs and Trade ("GATT") after the Superfund tax on imported oil was raised above that on domestic oil by the Superfund Amendments and Reauthorization Act of 1986. A GATT panel convened to investigate the complaint concluded that the differential petroleum tax rate is contrary to the GATT, and the panel ruling was accepted unanimously by the GATT Council on June 17, 1987. Under GATT rules, the United States either must amend the Superfund tax or compensate the plaintiffs to avoid possible retaliation.

President's Budget Proposal

The President's budget proposes a revenue neutral change in the Superfund excise taxes on domestic crude oil and imported petroleum products (including crude oil): increasing the rate on domestic crude oil (presently 8.2 cents per barrel) and lowering, to an equal level, the rate on imported petroleum products (presently 11.7 cents per barrel).

9. Repeal of the Crude Oil Windfall Profit Tax

Present Law

An excise tax is imposed on the windfall profit element of the price of domestically produced crude oil when it is removed from the premises on which it was produced. The windfall profit is defined as the excess of the sale price over the sum of the adjusted base price (adjusted for inflation and for grade, quality, and field) plus the applicable State severance tax adjustment.

The tax rates and recent base prices applicable to taxable crude oil are as follows:

Category of oil	Tax rate (percent)	Adjusted base price [1] (dollars per barrel)
Tier-1 Oil (oil not in tiers 2 or 3):		
Integrated producer	70	$18.84
Independent producer	50	19.44
Tier-2 Oil (stripper and petroleum reserve):		
Integrated producer	60	21.99
Independent producer [2]	30	NA
Tier-3 Oil:		
Newly discovered oil [3]	20	28.54
Incremental tertiary oil	30	28.07
Heavy oil	30	23.91

[1] Estimate of average adjusted base price for third quarter of 1987.
[2] Independent producer stripper well oil is exempt from tax.
[3] Rate phases down to 15 percent in 1989.

The tax is scheduled to phase out over a 33-month period beginning no later than January 1991.

President's Budget Proposal

The President's budget proposal would repeal the windfall profit tax.

Prior Action

During the 99th Congress, a Senate amendment to H.J. Res. 668 (a bill to increase the Federal debt limit) would have repealed the windfall profit tax. H.J. Res. 668 was not enacted.

The President's budget for fiscal year 1988 proposed to repeal the windfall profit tax. The Revenue Bill of 1987, as submitted by the Senate Finance Committee to the Senate Budget Committee in October 1987, included a provision to repeal the windfall profit tax. This provision was not included in the reconciliation bill as passed by the Senate. A Senate amendment to H.R. 3, the omnibus trade bill (currently in conference), also would repeal the windfall profit tax.

10. Repeal of Tax Reduction Trigger for Aviation Excise Taxes

Present Law

Excise taxes are imposed on air passenger tickets (8 percent), domestic air freight (5 percent), international passenger departures ($3), and fuels for noncommercial aviation (12 cents per gallon on gasoline and 14 cents per gallon on other fuels). The Airport and Airway Revenue Act of 1987 (the 1987 Act) extended these taxes through December 31, 1990.

Revenues from the aviation excise taxes are transferred to the Airport and Airway Trust Fund to finance Federal airport and airway programs. The 1987 Act provides for an automatic 50-percent reduction ("tax reduction trigger") in the aviation excise taxes (other than the $3 departure tax) in calendar year 1990, if the total appropriations for fiscal years 1988 and 1989 for airport improvements, facilities and equipment, and research, engineering and development are less than 85 percent of the total amounts authorized for these three programs for fiscal years 1988 and 1989.

President's Budget Proposal

The President's budget proposal would repeal the aviation "tax reduction trigger" for 1990.

B. Private Mediation of Tax Controversies

Present Law

When a taxpayer receives notice from the IRS that it has determined a deficiency of tax, the taxpayer may, before paying the deficiency, petition the United States Tax Court within 90 days after the notice of deficiency was mailed for a redetermination of the deficiency. This jurisdiction is provided by section 6213 of the Internal Revenue Code of 1986.

At the option of the taxpayer and the concurrence of the Tax Court, income tax disputes involving less than $10,000 for any one taxable year can proceed through the Tax Court pursuant to special "small tax case rules," which provide for expedited pretrial procedures and trials conducted as informally as possible consistent with orderly procedure. Neither the taxpayer nor the Government may appeal the decision of the trial judge in a small tax case.[2]

As an alternative to filing a petition in Tax Court, the taxpayer may pay the deficiency and file a claim for refund of the disputed amount with the IRS. If the IRS rejects the refund claim, or does not act within six months, then the taxpayer may bring an action for refund in Federal district court or the United States Claims Court, but not the Tax Court. This jurisdiction is provided by 28 U.S.C. sections 1346(a)(1) and 1491. There is no statutory authority for resolution of tax disputes in any forum other than these three courts, once the IRS has determined that a deficiency exists.

As of February 1988, the Tax Court had a backlog of over 74,000 pending cases, which is approximately three times the number of Tax Court cases pending in 1978.[3] Recently, however, the backlog of pending Tax Court cases has been diminishing: in February 1987, 83,000 cases were pending before the Tax Court. Currently, there is no significant backlog of small tax cases in Tax Court.

President's Budget Proposal

The Budget Message of the President states: "The Federal Government should also depend more on the private sector to provide ancillary and support services for activities that remain in Federal hands. Therefore, I am proposing the development of a private mediating institution to reduce the backlog of cases before the U.S. Tax Court." [4]

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[2] Sec. 7463 and Tax Court Rules 171–179.

[3] During the same time period, the number of tax returns filed increased by approximately 22 percent.

[4] *United States Budget in Brief, Fiscal Year 1989*, The Budget Message of the President, at 12.

C. Customs Service User Fee

Present Law

An *ad valorem* user fee is applied to all formal entries of merchandise imported for consumption. The fee, which currently is 0.17 percent of value, is scheduled to expire after September 30, 1990. The user fee is intended to provide revenue equal to the costs of the Customs Service commercial operations.

In the Omnibus Budget Reconciliation Act of 1987, collections from the fee were reclassified as offsets to outlays, rather than as receipts. For imported goods made with U.S. components, the Act exempted only the value of the U.S. component from the fee, rather than the total value of the good. A ruling of the General Agreement on Tariffs and Trade (GATT) indicates that correcting legislation is needed to make the user fee consistent with GATT requirements.

President's Budget Proposal

Legislation will be proposed to ensure that the *ad valorem* fee structure represents the costs of processing individual entries and that collections from the fee are reclassified as budget receipts.

D. Debt Collection: Extension of Program for Collection of Nontax Debts Owed to Federal Agencies

Present Law

Federal agencies are authorized to inform the IRS that a person (who has received proper notification from the agency) owes a past due, legally enforceable, debt to the agency. The IRS then must reduce the amount of any tax refund due the person by the amount of the debt and pay that amount to the agency. The refund offset applies to individuals and corporations. This program is scheduled to expire after June 30, 1988.

President's Budget Proposal

The baseline in the President's budget proposal assumes that this program will be extended, but the period of extension is not specified.

Prior Action

In the Omnibus Budget Reconciliation Act of 1987, the debt collection program was extended for six months (December 31, 1987 through June 30, 1988), expanded to apply the refund offset also to corporations, and expanded to cover all Federal agencies.

II. ADMINISTRATION'S ESTIMATED BUDGET EFFECTS OF THE PRESIDENT'S REVENUE PROPOSALS, FISCAL YEARS 1988–1993

[Millions of dollars]

Provision	1988	1989	1990	1991	1992	1993
A. Tax Provisions						
1. Extension of Medicare payroll tax to all State and local government employees		1,615	2,100	2,140	2,170	2,190
2. Treatment of mutual fund shareholder expenses with respect to the 2-percent floor on miscellaneous itemized deductions		−412	−494	−593	−712	−855
3. Exclusion for interest on higher education savings bonds		−10	−46	−101	−150	−199
4. Tax credit for qualified research expenditures		−401	−816	−1,023	−1,195	−1,361
5. Allocation and apportionment of research expenses	−387	−625	−686	−749	−814	−887
6. Foreign corporation branch tax credit		−30	−53	−58	−64	−70
7. Modification of oil and gas depletion rules		−52	−49	−38	−19	−5
8. Elimination of Superfund petroleum tax differential [1]					709	1,173
9. Repeal of crude oil windfall profit tax [1]	−12	−16	−10	−12	−22	−15
10. Repeal of tax reduction trigger for aviation excise taxes [1]			909	1,590	1,740	1,889
Subtotal: Tax Provisions	**−399**	**69**	**855**	**1,156**	**1,643**	**1,860**
B. Private Mediation of Tax Controversies						
C. Customs Service User Fee [1]	**662**	**560**	**539**	**522**	**505**	**486**
D. Extension of Debt Collection						
Grand Totals	**263**	**629**	**1,394**	**1,678**	**2,148**	**2,346**

[1] Net of income tax offsets.

SOURCE: U.S. Department of Treasury, Office of Tax Analysis.